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**Quarterly  
Economic  
Commentary**

July 1979



The Fraser of Allander Institute for Research on the Scottish Economy was established in the University of Strathclyde on 1 January 1975, as the result of a generous donation from the Hugh Fraser Foundation. Its principal function is to carry out research on the Scottish economy and its research programme includes the analysis of short term movements in economic activity. The results of this work are published each January, April, July and October in the Institute's Quarterly Economic Commentary. The Institute also publishes a series of Research Monographs to provide an outlet for original quantitative research on the Scottish economy, and a series of occasional essays on economic policy entitled Speculative Papers.

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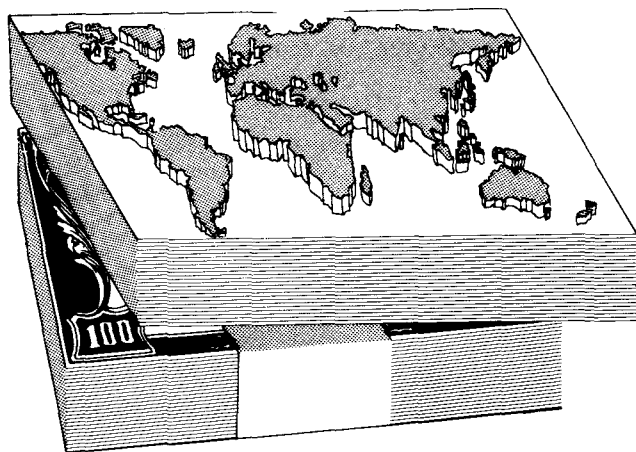
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*The views expressed in the Special Articles are those of the authors and not necessarily those of the Fraser of Allander Institute*

# The World Economy



The world price of crude oil has risen by some 30% in the last six months, having remained roughly constant, in real terms, since the first quarter of 1974. The latest increase was made possible by changes in market conditions, notably the interruption in supplies from Iran. The oil price rise will add some 2½ percentage points to the rate of inflation of consumer prices in the industrialised countries, and perhaps reduce the rate of growth of industrial output in the world from about 3% to about 2% next year.

This is certainly serious news for the non-oil producing poorer countries of the world, but it is not an event which can justify the hysteria with which it has been greeted by the media of the richer countries. Indeed the price rise may evoke that necessary reduction in consumer demand, and accelerate the search for substitute technologies and commodities which political

exhortation has so far failed to achieve. It should also have the effect of transferring balance of payments surpluses (and real incomes) from countries like Japan and West Germany to the OPEC countries.

Japan's chronic export surplus has undoubtedly been one of the destabilising features of the world economy in the past decade, compelling her trading partners, if they are unwilling or unable to run a corresponding deficit, to choose between domestic deflation or trade restrictions. However, Japan's current account surplus of \$12 billion in fiscal year 1978 is expected to be only around \$6 billion in fiscal year 1979, while some forecasters go so far as to suggest that Japan's current balance will move into deficit this year. Despite oil price increases, the rate of inflation in Japan should still not exceed last year's figure of 4.5%, while GDP growth is expected to fall to around 4% in real terms.

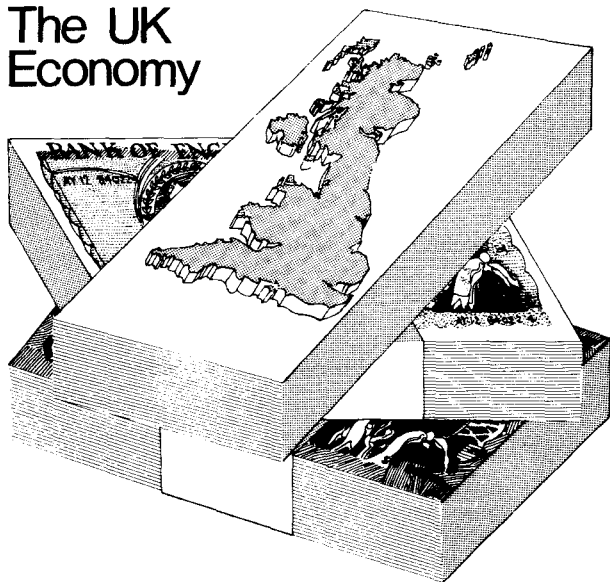
West Germany is the only major industrial country, other than Italy, where the growth of GDP in 1979 is expected to be higher than in 1978. However, the rate of inflation is likely to rise to about 3.5%, with a slight fall in unemployment.

In the United States, the rising cost of fuel has helped to accelerate the fall in car and truck sales which is a key indicator of the long-awaited mini-recession. Whereas there was real GNP growth of just 0.8% in the first quarter of this year, preliminary official estimates suggest that, in the second quarter, real GNP fell by 2% at an annual rate. More seriously, perhaps, retail prices rose at an annual rate of 13.5% in the first five months of the year. It therefore seems likely that during 1979 the consumer price index will move into double figures, and the real growth rate of GNP will drop from the 4% in 1978 to 2% in 1979.

The 'Tokyo Summit' meeting of the heads of government of the seven major industrialised countries which took place at the end of last month was encouraging in that a constructive response was agreed to the oil price increase. In particular, the closing communique publicly set its face against protectionism. The other danger which faces world trade in the next two years, is that the US may try to eliminate its external trade deficit by the deflation of domestic demand at a time when other industrialised countries, notably West Germany, Japan and the UK, are also deflating. To avoid this prospect it has been suggested that trade surpluses and deficits could be redistributed, by the introduction of positive discrimination, into tariff and other international trade policies. Specifically, it has been suggested that the rich countries should discriminate in favour of manufactured exports from the non-oil poorer countries, and against manufactured exports from Japan. Whatever the merits of this proposal from a purely economic standpoint, it is naive to suppose that it would be anything but politically divisive.

The principal hope of obtaining all-round international agreement still lies with the negotiations under the auspices of GATT, now drawing to a close at Geneva. Multilateral reductions of tariffs on manufactured goods were agreed in principle last April, though there still remains disagreement over the phasing of the reductions over the eight years from 1980.

## The UK Economy



The UK economy continues to be depressed and is likely to remain so over the coming year. Preliminary estimates suggest that GDP fell in both the final quarter of 1978 and the first of 1979, and this pattern is likely to have persisted into the second quarter of this year. Indicators in the early months of 1979 were distorted by widespread industrial action, accounting in part for the 1% drop in GDP during the first quarter. However, though industrial production subsequently recovered rapidly, the level for the quarter as a whole remained below the average 1978 level, suggesting a zero or even negative underlying rate of growth. Recent falls in registered unemployment are therefore unlikely to be maintained and will probably be reversed given the conjunction of deflationary forces which the UK economy faces.

The recent changes in economic policy, namely the shift from direct to indirect taxation and the planned reduction in the size of the public sector, are likely to further depress the level of activity in the short run. However desirable or overdue such a recasting

of policy may have been, and however successful their long run consequences, it nevertheless appears that the short run effects, both direct and indirect, may be perverse.

The factors tending to depress the level of activity over the coming year are firstly budgetary and domestic factors, and secondly the exogenous rise in energy prices. Consider each of these in turn. The tax changes in the budget imply a mild stimulus to activity for the remainder of this year. The direct tax changes involve an injection of £3.6 billion into the economy, while the indirect tax measures withdraw £2.4 billion. This net injection results primarily from the backdating of the direct tax changes to the beginning of the financial year, while the indirect tax measures only take effect from mid-June. (Over a full year however the net effect of the measures would be deflationary). The stimulus to activity from these fiscal manoeuvres will be offset by the public expenditure cuts of £1.6 billion, while the effects of cash limits are expected to reduce planned programmes by a further £1 billion in 1979-80. Such are the direct effects of the budget.

The indirect effects are also of importance and also deflationary. The VAT charges are expected to add 4-4½% to the Retail Price Index. The twelve monthly rate of price inflation at the onset of the next pay round in August will therefore be at least 15%; not only high but also rising. The effect on wage expectations and demands is obvious. Such demands will be made in the context of an avowedly inflexible monetary policy. The approach currently being taken to curb the rate of growth of the broad money supply ( $M_3$ ) at present necessitates an MLR of 14%.

Maintenance of such a high level of interest rates helps to inflate the exchange rate, thereby reducing export profitability and increasing import penetration, effects which are only to a small extent offset by the beneficial effect on the rate of price inflation. Given the current rate of return on capital, MLR of 14%

is unlikely to encourage investment in productive assets, while for many house-buyers the associated rise in mortgage interest rates may, at the turn of the year, completely absorb the effects of the direct tax changes introduced in the budget. Attempts by local authorities to recover the shortfall in the Rate Support Grant by poundage increases will further reinforce this effect.

External factors are also unfavourable. The OPEC inspired rise in energy prices, given the inelasticity of demand for such products, will depress the real level of non-energy final demand in both the UK and its trading partners. The volume of world trade is therefore unlikely to be buoyant over the coming year. The UK's role as an important oil producer and exporter confers upon it an advantage not shared by our trading partners as the price of UK oil exports rises in line with those of OPEC. This advantage may be offset by the resulting strength of sterling and consequential reductions in exports.

All components of final demand would therefore appear weak over the coming year. Little growth is likely in consumer's expenditure as real incomes contract. Furthermore, the higher perceived rate of inflation may lead to a rise in the savings ratio in an attempt to reconstitute real balances. Central government expenditure is likely to fall marginally, while capital investment may also contract in the face of weak domestic and export demand. The budget forecasts suggest that GDP will fall by 1% between mid 1979 and mid 1980.

Given the current sterling effective exchange rate, demand conditions in export markets and the rising trend of price inflation, the number of unemployed in the UK will rise significantly over the coming year regardless of the level of wage settlements. The level of such settlements will however determine the length of time during which this higher level of unemployment will persist. Wage settlements consistent with the current stance of monetary policy imply a short run fall in real incomes, with consequent downward pressure on the derived demand for labour. Wage settlements inconsistent with the 7-11% rate of growth of  $M_3$  can only be accommodated by a reduction in the level of employment. Under both scenarios the level of unemployment rises. Under the first however, the UK is reasonably placed to participate in the future recovery of the world economy. The second, by contrast, merely postpones the required adjustment, and represents a repetition of the UK experience of 1974-76. This second scenario, oft repeated in the UK, invariably degenerates into an incomes policy, while on past performance the first can only be attained by means of such a policy.

It will be interesting to observe how long the government can maintain their resolve to avoid the introduction of incomes policy.